

**"NET BANK INTEREST MARGIN AND INTEREST RATE
RISK AMONG COMMERCIAL BANKS IN KENYA"**

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**A MANAGEMENT RESEARCH PROJECT SUBMITTED IN
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ABSTRACT

This study set out with the objective of determining the relationship between net bank interest margin and interest rate risk among registered commercial banks operating in Kenya as of 31st march 2004. This study was inspired by among others, Hanweck's (2005) George Mason University working paper 2005-02 "The Sensitivity Of Bank Net Interest Margins And Profitability To Credit, Interest-Rate, And Term Structure Shocks Across Bank Product Specialization". To do this, five regression models were developed using net interest margin and interest rate risk variables data for the period between the fourth quarter of 2002 to the second quarter of 2005.

Net interest margin was measured by average net interest income as a percentage of average earning assets while interest rate risk indicators used were the volatility of 91-day monthly treasury yield (VOL_1Y), net short term assets as a percentage of earning assets (STGAP_RAT), non-maturing deposits as a percentage of earning assets (NM_RAT), with a dummy variable (ST_DUMMY) introduced to capture marginal effect when VOL_1Y increased in the quarter. Two interaction terms between the dummy and; STGAP_RAT and NM_RAT respectively, capture the marginal effect of an increase in these variables when short-term interest rates rise.

The study found out that interest rate risk contributes 50.4% influence of the total variations of net bank interest margin of commercial banks in Kenya. With 18.8% variation in NIM when the risk is measured by the volatility of the 91-day monthly treasury yield, 32.3% when the risk is measured by the net short term assets as a percentage of earning assets and 33.0% if measured by the non-maturing deposits as a percentage of earning assets.

This implies that if the Central Bank of Kenya (Amendment) Act, 2002 commonly referred to as the 'Donde Bill' from which the Minister of Finance has invoked several clauses, and that which provides that the bank interest rates be pegged on the 91-day Treasury bill fully comes into force, the bank interest rates will strongly be influenced by the volatility of the treasury yield and thereby bank NIM. Meaning that in the long run commercial banks in Kenya will no longer rely on interest generated income as their main source of income, and that they will have to move from their traditional intermediation role and towards other innovative ways of raising fee income.